DEPARMENT OF STATE REVENUE
LETTER OF FINDINGS: 99-0351
INDIANA GROSS INCOME TAX
For the 1991 Through 1997 Tax Years

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ISSUE

I. Gross Income Tax Assessment Against Nonresident Taxpayer's Receipts Acquired Under a Contract For Work to Be Performed in Indiana.

Authority: U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV; IC 6-2.1-1-2(a); IC 6-2.1-2-2; IC 6-2.1-2-2(a)(2); Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue, 107 S.Ct. 2810 (1987); Bethlehem Steel v. Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue, 598 N.E.2d 647 (Ind. Tax Ct. 1992); 45 IAC 1-1-49; 45 IAC 1-1-120.

Taxpayer protests the audit's assessment of Indiana's gross income tax on receipts derived from a contract for work to be performed in Indiana. Taxpayer argues that it does not have nexus with Indiana and that, as a consequence, the assessed gross income tax is inappropriate.

II. Request for Abatement of the Ten-Percent Negligence Penalty.

Authority. 45 IAC 15-11-2(b); 45 IAC 15-11-2(c); IC 6-8.1-10-2.1(a); IC 6-8.1-10-2.1(d).

Taxpayer requests that the Department exercise its discretionary authority to abate the ten-percent negligence penalty associated with the imposition of taxpayer's state's gross income tax liabilities.

III. Request for Abatement of Interest.

Authority. IC 6-8.1-10.

Taxpayer has requested that the interest, which has accumulated against its gross income tax liabilities, be abated.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation with its principal place of business located in Virginia. Taxpayer is in the business of providing specialized computer and information processing services. Taxpayer entered into a multi-year contract with the federal government. The contract called for the design and implementation of a logistic system to support the receipt, segregation, storage, and issuance of supplies. The contract negotiations took place in Washington, D.C. Taxpayer's representatives did not enter into Indiana in order to negotiate the contract. Taxpayer has no property, employees, or activities in Indiana other than holding the contract for services to be provided in Indiana. Under the terms of the, contract, the work began in 1990 and continued until 2000. The contract was to be performed at various government installations throughout the United States including Indiana. In order to fulfill the terms of the contract, work was performed – through taxpayer's subsidiaries – at three Indiana locations. Under the terms of the contract, taxpayer agreed to provide "Automatic Data Processing Support Services" at one specific Indiana location. According to the taxpayer, the work performed in Indiana was completed by two of its wholly owned subsidiaries. These two subsidiaries filed Indiana corporation income tax returns for the years at issue. In those returns, the two subsidiaries reported the income derived from the contract entered into between taxpayer and the federal government. The proposed assessment – subject of the taxpayer's protest – purportedly calls for the identical gross income attributable to taxpayer, as the parent company, to be taxed again at the parent company level.

DISCUSSION

I. Gross Income Tax Assessment Against Nonresident Taxpayer's Receipts Acquired Under a Contract For Work to Be Performed in Indiana.

Taxpayer protests the gross income tax assessment on the grounds that it does not have nexus with the state of Indiana and that imposition of the tax offends the provisions of the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, and the Due Process Clause, U.S. Const. amend. XIV, § 1. More specifically, and as a basis for its assertions, taxpayer maintains that it does not have employees or property within the state. Taxpayer maintains that it did not perform any of the work attributable to its contract with the Department of Defense. Taxpayer argues that it contracts out all of the work performed under the contract, and that the actual contract work is performed by certain subcontractors including its own wholly owned subsidiaries.

Taxpayer sets out a second, general equitable argument in which it asserts that imposition of the tax is inappropriate because its two subsidiaries – the entities actually performing the work in Indiana – have filed Indiana corporate income tax returns and have already paid tax upon receipts derived from performance of the contract.

Under the provisions of IC 6-2.1-2-2, the Indiana gross income tax is imposed on the receipt of "the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." IC 6-2.1-2-2(a)(2).

The Indiana tax court has set forth a three-part test to determine whether a non-resident taxpayer is subject to imposition of the gross income tax. The taxability of a non-resident taxpayer is dependent on determining whether (1) the taxpayer's receipts constitute "gross income," (2) whether the "gross income" is derived from "sources within Indiana," and (3) whether the "gross income," derived from those sources within Indiana, is "taxable gross income." Bethlehem Steel v. Dept. of State Revenue, 597 N.E.2d 1327, 1330 (Ind. Tax Ct. 1992), *aff'd* 639 N.E.2d 264 (Ind. 1994); *See also* Indiana-Kentucky Elec. Corp. v. Indiana Dept. of State Revenue, 598 N.E.2d 647, 661 (Ind. Tax Ct. 1992).

As a preliminary question, it must be determined that the receipt of income from the performance of the contract represents Indiana gross income. IC 6-2.1-1-2(a) provides that "[e]xcept as expressly provided in this article, 'gross income' means all the gross receipts a taxpayer receives . . . from the performance of contracts." Taxpayer entered into a contract to perform certain, particularized computer services for the Defense Department. Subsequently, taxpayer received payment for the performance of those services. Under IC 6-2.1-1-2(a), those receipts constitute "gross income" for the purpose of determining the applicability of the state's gross income.

It is the second provision of the Bethlehem Steel test which is central to taxpayer's protest. In order for the Department to establish that taxpayer's income is subject to the state's gross income tax, the Department must find that the taxpayer's income is derived from a source within Indiana. Specifically, "[i]f the activities giving rise to the income sought to be taxed do not occur within Indiana, then the tax may not be levied – not because to do so is forbidden by the United State Constitution (although it may well be) – but rather because under those facts the levy is forbidden by the statute." Bethlehem Steel, 597 N.E.2d at 1330. 45 IAC 1-1-120 instructs in part that "[a]s a general rule, income derived from sales made by nonresident sellers to Indiana buyers is not subject to gross income tax unless the seller was engaged in business activity within the State [i.e., business situs] and such activity was connected with or facilitated the sales [i.e., tax situs]." The court in Indiana-Kentucky explained, stating that "the regulations teach that a nonresident is subject to taxation if the 'source' of the gross income is an Indiana *tax situs*, i.e., an Indiana *business situs* at which business activities are performed that are connected with or facilitate the transaction . . . giving rise to the gross income." Indiana-Kentucky, 598 N.E.2d at 662 (Emphasis added).

As the audit determined, taxpayer has an Indiana business situs as represented by the taxpayer's execution of a contract to provide service within the state of Indiana. Specifically, the regulation provides that "[f]or purposes of these regulations . . . a taxpayer may establish a 'business situs' in ways including but not limited to . . . [the] Performance of services." 45 IAC 1-1-49.

However, to determine tax situs, it must be determined whether the transaction giving rise to taxpayer's gross income are related to taxpayer's Indiana activities. In addition, it must be determined that the related Indiana activities are "more than minimal, and not remote or incidental to the total transaction . . . ." Indiana-Kentucky, 598 N.E.2d at 663.

Taxpayer entered into a long-term contract for the provision of computer services. The parties' contract specified that computer services were to be performed at an Indiana location. Taxpayer's gross income was clearly related to its Indiana activities because performance of the Indiana activities were inherently necessary to the fulfillment of the contract. Because the income was derived from the performance of its contractual obligations within Indiana, taxpayer's Indiana activities rose to a level which was neither minimal nor incidental to the relevant transactions.

Taxpayer argues that it does not have sufficient nexus with the state because the actual contract is being performed by two of its wholly owned subsidiaries. However the Supreme Court rejected a similar argument in Tyler Pipe Industries, Inc. v. Washington State Dept. of Revenue, 107 S.Ct. 2810 (1987).

> Tyler argues that its business does not have a sufficient nexus with the State of Washington to justify the collection of a gross receipts tax on its sales . . . . Tyler maintains no office, owns no property, and has no employees residing in the State of Washington. Its solicitation of business in Washington is directed by executives who maintain their offices out-of-state and by an independent contractor located in Seattle. Id. at 2821 (Internal emphasis omitted).

The Supreme Court explicitly rejected Tyler's argument agreeing with the state court's decision that Tyler, by virtue of its representatives' activities, had sufficient nexus with Washington state.

> As the Washington Supreme Court determined, "the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales." The court found this standard was satisfied because Tyler's "sales representatives perform any local activities necessary for maintenance of Tyler Pipe's market and protection of its interest . . ." Id. (Internal citations omitted).

The Supreme Court concluded that Tyler could not defeat a nexus determination by insulating itself from the taxing state by virtue of the intervening activities of an independent contractor. "[A] showing of a sufficient nexus could not be defeated by the argument that the taxpayer's representative was properly characterized as an independent contractor instead of as an agent." Id.

Taxpayer entered into a contract the terms and performance of which establish both a business and tax situs for purposes of the state's gross income tax. The fact that taxpayer's subsidiaries are engaged for the purpose of performing the terms of the contract, is an irrelevancy.

Additionally, taxpayer challenges imposition of the gross income tax on constitutional grounds. Taxpayer argues that imposition of the tax against an out-of-state taxpayer is offensive to the Commerce Clause and the Due Process Clause. To the extent that taxpayer challenges the constitutionality of the Indiana's gross income tax scheme, taxpayer raises issues which are beyond the purview of this administrative review. Taxpayer's wholesale constitutional challenge will not be addressed here.

Similarly, taxpayer's generalized equitable argument must also fail. The Department is without authority to grant taxpayer an equitable adjustment to a tax assessment properly levied under Indiana's statutes and regulations.

FINDING

Taxpayer's protest is respectfully denied.

II. Request for Abatement of the Ten-Percent Negligence Penalty.

Taxpayer has requested that the ten-percent negligence penalty, imposed under authority of IC 6-8.1-10-2.1(a), be abated. The penalty was assessed against taxpayer's cumulative gross income tax liabilities determined for the tax years 1991 through 1997.

IC 6-8.1-10-2.1(d) states that if a person, subject to the negligence penalty, imposed under IC 6-8.1-10-2.1(a), can show that the failure to file a return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay the deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45 IAC 15-11-2(b) defines "negligence" as the failure to use the "reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer." Negligence results from a "taxpayer's carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations." Id.

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax due was due to "reasonable cause." 45 IAC 15-11-2(c). Taxpayer may establish reasonable cause by "demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ." Id. In determining whether reasonable cause exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

Regardless of the Department's determination concerning taxpayer's gross income tax liability, under IC 6-8.1-10-2.1(d), taxpayer – as an out-of-state entity having no substantive assets located within the state – has established that its failure to file Indiana corporate income tax returns during the relevant tax years was due to "reasonable cause and not due to willful neglect . . . ." However erroneous its failure to file Indiana corporate tax returns may have been, taxpayer, by its interpretation and application of the relevant statutes and regulations, has demonstrated that it exercised "ordinary business care" in determining that it did not have sufficient nexus with the state and that it was not subject to the state's gross income tax scheme.

FINDING

Taxpayer's protest is sustained.

III. Request for Abatement of Interest.

Taxpayer protest the imposition of interest against the assessed taxes and requests that the interest which has accumulated on those taxes be abated. Under IC 6-8.1-10-1(a), if a person incurs a deficiency upon a determination by the Department, "the person *is* subject to interest on the nonpayment." (Emphasis added).

The Department has no discretion regarding the imposition of interest. Under 6-8.1-10-1, the accumulated interest may not be abated for any reason and the Department must decline taxpayer's invitation to do so.

FINDING

Taxpayer's protest and request for abatement is respectfully denied.

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